RESERVE BANK
OF NEW ZEALAND
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New Zealand house prices have seen a significant rise in the past 12 months which has raised concerns here at the Reserve Bank of the vulnerabilities that this poses to the economy's financial stability.

BACKGROUND

Central banks responded swiftly to the global economic shock caused by COVID-19. They did this through various initiatives, including by buying government debt; and lowering banks' funding costs – making more money available for customers to borrow at cheaper rates. These initiatives were complemented by the support provided by Government policies and helped to avert a more serious financial crisis, but also had the flow-on effect of boosting asset prices.

In our case, house prices climbed from already elevated levels, and saw debt levels rise with them. This has led to pockets of vulnerability as some households leveraged up to buy homes at historically high prices. Nationwide, house prices rose by 24 percent in the 12 months to March 2021 and now appear to be stretched by several metrics, including the ratio of house prices to borrowers' incomes, and the affordability for those entering the market. This doesn't just affect buyers, as we have also seen an above-inflation growth in the cost of rent.

Resilient household incomes, bolstered by wage subsidies, strong migration levels prior to the border closure, and supply constraints – including land use restrictions and barriers to the supply of infrastructure have also contributed to the recent surge in prices.

The cost of servicing a new mortgage compared to renting remains relatively low, and the rental returns based on current house prices have declined to a lesser extent than alternative long-term investments. These factors point to a degree of sustainability in the current level of prices, and suggests that buyers do not anticipate a material increase in housing supply. But, as with the levels of many global asset prices, and the pace of their recent rise, the sustainability of house prices in New Zealand has been called into question.

RISKS

Long-term interest rates have been trending down for decades, and the global monetary policy response to the COVID-19 pandemic brought them even lower. However, this doesn't mean that the trend won't reverse. A disorderly unwinding of monetary policy support could see abrupt adjustments in asset prices, posing a particular risk to those who have purchased at the current elevated levels.

Mortgage borrowers, particularly those who entered the market recently, are vulnerable to a rise in interest rates. The Reserve Bank estimates suggest that for a typical recent owner occupier borrower, an increase in the one-year mortgage rate to 5 percent would increase their debt servicing ratio from under 30 percent currently to nearly 50 percent. Investors are expected to show a larger debt servicing ratio increase to interest rate rises, although on average they have higher incomes to deal with the shock and can raise rents in response.

Any large increases in debt serviceability burdens can produce negative feedback effects on the economy, as highly-indebted households reduce their consumption spending, and particularly distressed borrowers default on their loans.

OUTLOOK

Current demand and supply conditions may prove temporary and are subject to uncertainty. Indeed, new housing supply is starting to outstrip population growth given the border restrictions. But ultimately, for the housing affordability problem to be resolved, policy constraints on supply needs to be addressed. The Government's recent extension to the bright line property tax, and the phased removal of interest expense deductibility will materially reduce the prospective after-tax returns available.

The Reserve Bank has also reinstated mortgage loan-to-value ratio (LVR) restrictions to reduce the risk that the housing market could cause in a wider economic downturn. The LVR policy has been reinstated with more restrictive settings for investors, reflecting the heightened risks that they carry.

Positively, a moderation of house prices on its own would be unlikely to pose a significant risk the soundness of the banking system, owing partly to resilience that the LVR policy has brought over the past seven years. Furthermore, homeowners who purchased in the past few years have seen strong growth in house prices, and a steady decline in mortgage rates, which has provided them with a good equity cushion. This means there is a limited prospect of negative equity for most recent buyers, unless a house price decline was very severe. Stress tests conducted by the Bank in 2020 also showed that banks would be resilient in a scenario with high unemployment and a large fall in house prices.